Making the Case for a Dedicated NOAH Strategy

Bridge Investment Group's Inna Khidekel discusses the benefits of naturally occurring affordable housing for institutional investors.

By Inna Khidekel, Affordable Housing Finance, June 25, 2018

The emergence of "naturally occurring affordable housing" (NOAH) as a distinct and investable asset class, with sufficient scalability for institutional investment, is relatively recent. This asset class has been slow to gain stand-alone recognition for three reasons: 1) institutions have traditionally viewed an investment in affordable housing as synonymous with tax credits and government subsidies; 2) without the labels associated with the Sec. 42 low-income housing tax credit program or the Department of Housing and Urban Development's Sec. 8, NOAH assets have largely flown under the radar; despite their unique operating characteristics, they have often been mistakenly grouped together with market-rate multifamily; and 3) a lack of cohesive, large-scale support has historically limited affordable housing finance to government subsidies, Community Development Financial Institutions, or regional financing.

As the affordable housing crisis in the United States deepens, with fewer than one in 10 deliveries today considered affordable and the expected decline of 235,000 government-subsidized units over the next 10 years, the interest in a private-sector solution focused on the preservation and rehabilitation of NOAH without reliance on government subsidies has vastly increased among institutions.

In order to assess the suitability of this asset class for the institutional market, it is necessary to define its scalability and depth. Dividing market-rate properties within a metro area based on the maximum rent that a family could pay without being cost-burdened, typically defined as less than 30% of income spent on rent accounting for utilities and insurance, and applying this to the 60% to 80% of the area median income (AMI) level illuminates the inventory available for a NOAH strategy. Focusing on the households that earn 60% to 80% of the AMI is ideal for a NOAH strategy as this population, often referred to as the "missing middle," has increasingly been priced out of market-rate multifamily during this cycle, yet earns too much to qualify for government-subsidized housing programs. This segment of the U.S. workforce comprises many of the police officers, firefighters, teachers, and health-care workers in our communities.

While each metro area identifies a different rent threshold, an aggregate analysis within 38 focus markets reveals 72% of multifamily properties over 100 units qualify as NOAH at the sub-80% AMI level. In fact, the NOAH pool is larger than the historical definition of affordable housing (i.e., government-subsidized) by a factor of four.

With the NOAH market proving to be not just significant, but actually four times the size of the asset class traditionally defined as affordable housing, an institution can explore the second impetus for an investment: NOAH has distinct and highly favorable operating characteristics that differentiate it from market-rate multifamily. In the current

cycle, construction costs, zoning laws, “Not in My Back Yard” challenges, and regulatory burdens have caused developers to build almost exclusively luxury Class A housing, unaffordable to roughly 80% of American renter households; meanwhile, the supply of affordable housing is rapidly diminishing due to obsolescence or market-rate players raising rents.

Eighty-five percent of NOAH properties are Class B or C, precisely where the supply constraints are most pronounced. A rehabilitation strategy that transforms NOAH properties into sustainable, thriving communities while preserving affordability leverages this supply-demand mismatch, which in turn creates a strong and stable investment thesis.

NOAH properties currently benefit from a 5% average occupancy rate advantage over non-NOAH, at a record ~95% occupancy level, which translates to steadier cash flows, diminished volatility both in normalized and recessionary environments, and a strong risk-adjusted market return. Average effective rent growth is higher for NOAH properties, but particularly so when adjusted for volatility. NOAH has demonstrated significantly higher cap rates than non-NOAH over the past five years, with entry into the asset class currently offering a 100 basis point cap rate advantage. Furthermore, given the breadth of the asset class and the lack of constraints associated with a government-subsidized program, NOAH does not suffer from the liquidity and marketability limitations that hinder traditionally defined affordable housing. Typically older stock in need of rehabilitation, NOAH is particularly well suited to a hands-on, value-add investment approach that emphasizes environmental sustainability and quality of life enhancements, driving long-term value while preserving affordability.

As it relates to the third element, Freddie Mac has recently partnered with select real estate managers to finance NOAH-dedicated portfolios at favorable rates. Freddie Mac’s novel financing facility enables the execution of a scalable, institutional-level NOAH strategy that will preserve housing affordability while enhancing investor returns.

In supporting private-sector NOAH investment with flexible, attractive, and scalable financing in return for income and rent restrictions at the sub-80% AMI level, Freddie Mac meets its mission of supporting affordability within the U.S. multifamily housing system and partially offsets the magnitude of market-rate players pushing rents with Federal Housing Finance Agency (FHFA) financing. Furthermore, lending to a NOAH portfolio is now excluded from agency multifamily regulatory caps, which incentivizes additional FHFA backing and also highlights that the agency recognizes NOAH as a stand-alone asset class distinct from market-rate multifamily.

As the FHFA continues to support the private sector’s investment into nongovernment-subsidized affordable housing and hosts additional workshops with key industry participants dedicated to iterating on longer-term, permanent financing solutions, NOAH will gain even more marketplace momentum.

Ultimately, the continued limited supply and extremely strong and growing demand for affordable housing creates both a dire imperative and a compelling investment case for a dedicated NOAH strategy, particularly one executed by a high-touch owner-operator that meets resident needs and enhances social mobility on a nationwide scale.

Institutional investors, attracted to the strong risk-adjusted market returns, defensive risk profile, and steady and stable cash flows that can be scaled across a NOAH strategy, are beginning to allocate significant sums of capital to the asset class; this positive trend has the potential to make a significant dent to the affordable housing crisis in the United States, all without reliance on government resources.

Inna Khidekel is a managing director at Bridge Investment Group. The private equity real estate firm recently released a report, *NOAH's Pool: Assessing the Depth of Naturally Occurring Affordable Housing*